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TAGS: ECON EFIN OREP AR
SUBJECT: CODEL SHELBY DISCUSSES AGRICULTURAL STRIKE, GLOBAL
FINANCIAL CRISIS, BOND HOLDOUTS WITH FINANCIAL INSTITUTIONS

Ref: (A) Buenos Aires 422

(B) Buenos Aires 425

Summary

¶1. (SBU) Representatives of U.S. commercial banks, investment banks, insurance companies, and rating agencies told CODEL Shelby March 25 that the GoA's interventionist tendencies has scared off foreign direct investment (FDI) -- except from Brazil -- and long-term lending from the private sector, both crucial to sustainable growth. They called the ongoing agricultural sector strike the worst crisis the Kirchners have faced since 2003, and a direct challenge to their heterodox economic model. End Summary.

¶2. (SBU) Senator Richard Shelby (R-AL), Senator Judd Gregg (R-NH), Senator Bob Corker (R-TN), Senator Mike Crapo (R-ID), and Congressman Bud Cramer (D-AL) visited Buenos Aires March 23-26, meeting with the Justice Minister and Central Bank President (reftels), in addition to having lunch with representatives of all nine U.S. financial institutions operating in Argentina: CitiGroup, JP Morgan, Goldman Sachs, Prudential Financial, Merrill Lynch, Standard and Poor's, Moody's, Fitch Rating, and American Express. Highlights are provided below.

Changing Face of FDI; Lack of Long-Term Lending

¶3. (SBU) Participants agreed that GoA intervention in the economy and high inflation were both major constraints to both FDI and long-term lending in Argentina, and predicted this would limit Argentina's capacity to grow at high rates in the future. Fitch's rep commented that when there is no long-term macro planning by the government, it is difficult for businesses to look beyond the short term or access long-term financing. Goldman Sachs' rep argued that regular GoA market interventions have led directly to reduced interest from foreign investors. He added that such regular interventions have also encouraged both foreign and domestic investors to prioritize shorter-term projects, where the investor can recoup the investment within only a few years. Alternatively, investors are putting their money into real estate or other assets that will hold their value in a high-inflation environment.

¶4. (SBU) CitiGroup's rep reported that there is a similar situation with bank lending. Although private sector credit is growing rapidly, at about 40% per year, it is still low as a percentage of GDP and is increasingly dominated by short-term consumer credits. The Citi rep added that, because of high inflation and negative real interest rates, bank deposits average only 30-days. The combination of high inflation and short-term deposits precludes long term fixed-rate lending from banks to the private sector. He commented that, in any case, the banks are reluctant to take on the risk of long-term fixed rate loans, whereas companies do not want to risk long-term, variable rate loans. The compromise is that companies are rolling over short-term, fixed-rate loans, which limits their growth opportunities. In sum, Citi's rep commented, the banking sector's exclusive focus on short-term financing limits its ability to support continued economic growth. (Private sector credit in Argentina is approximately 14% of GDP, compared to over 20% prior to the 2001/2002 financial crisis, and compared to an average of almost 30% in Latin American and over 80% in developed economies.)

¶5. (SBU) JPMorgan noted that many smaller Argentine companies are financing themselves, either through retained earnings or by repatriating capital held abroad. (Estimates of Argentine capital held abroad are as high as $150 billion, including investments and capital flight.) JPM's rep also noted that the fall in FDI from traditional sources (U.S. and Europe) has been partially covered by increased investment from local groups and also from Brazilian companies, which are benefiting from the Real's appreciation against the Peso. Both are better positioned to understand the risks of doing business in the Argentine market, and both also have tacit GoA approval for their investments.

¶6. (SBU) Fitch's rep agreed, adding that the GoA's inability to issue debt internationally, and disinterest from traditional sources

of FDI, has forced it to create its own financing sources. For example, the GoA is forcing Argentine pension funds to repatriate a significant portion of capital they had earlier invested in other Mercosur countries, and this has led to a surplus of liquidity in the domestic market.

¶7. (SBU) In response to questions from the CODEL, various participants noted that there is no significant Chinese investment in Argentina, despite the increasing trading relationship between the two countries. The Goldman rep added that China has made significant investments in the region, particularly in energy, agriculture, and mining, and is reportedly looking at possible opportunities in Argentina. However, he noted that China is moving cautiously, because it still considers Latin American the "backyard of the U.S."

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Ag Strike Poses Challenge for K's Economic Model
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¶8. (SBU) JP Morgan's rep commented that the ongoing agricultural sector strike, which started with the GoA's March 11 announcement of much higher taxes on major agricultural export crops, is the worst crisis the government has faced since 2003. He also explained that the strike is a direct challenge to the Kirchners' economic model (the tax-the-farmers-to-build-the-welfare-state and support inefficient industry model on which Peronism and Kirchnerism is based).

¶9. (SBU) Because the rural area is not organized, and there are no clear representatives directing the striking farmers, the GoA has had having difficulty influencing the situation. Also, there are widely divergent views among farmers, particularly between the larger, more efficient commercial landholders and the smaller, less efficient farmers, whose livelihood is directly threatened by the new taxes. JP Morgan's rep speculated that the GoA would most likely be forced to roll-back the recent export tax increase, or at least create a dual system that differentiates between large and small producers. (Note: this prediction came true March 31, when the GoA announced measures to alleviate the impact on small and medium farmers.)

¶10. (SBU) JP Morgan's rep also noted that the original justification

for export taxes in Argentina was to balance out the beneficial impact to exporters of the GoA and Central Bank's policy of maintaining an undervalued or "competitive" peso. Therefore, on one hand the competitive exchange rate allows exporting farmers to earn huge returns in peso terms due to the high world prices for agricultural commodities. On the other hand, the GoA takes a percentage to be able to subsidize other sectors and consumers, so as to share the benefits with all of society. However, the JPM rep noted that the GoA is not taking into account the increases in the costs of production due to inflation and higher-priced imports. Therefore, farmers are being squeezed. (President Fernandez de Kirchner and her Economy Minister justified the March 11 tax increases as measures to keep down local food prices, foster income redistribution, and encourage crop diversification -- away from soy, which in the last ten years has dramatically increased its share of cultivated land from 30 to 45%.)

Deal Expected Eventually with Holdout Bondholders

¶11. (SBU) Although several of the participants agreed that the GoA will eventually work out some kind of deal with the so-called "holdout" bondholders (those who declined to participate in the 2005 debt exchange), there was also general agreement that the GoA would have a difficult time fully resolving the problem. JPMorgan commented that it would be almost impossible for the GoA to get 100% participation, if it were to re-open the debt exchange. However, he predicted the GoA would eventually re-open the exchange, and would likely get around 75% participation in a deal similar to or slightly worse than the original offer. Although the GoA would continue to experience difficulties with the remaining holdouts, it would show good faith to the U.S. and European courts (and ICSID tribunal) overseeing holdout lawsuits. The Ambassador noted that it was part of the USG's fiduciary duty to continue pressuring the GoA to reach

a mutually acceptable settlement with holdouts.

Limited Impact of Global Financial Crisis on Argentina

¶12. (SBU) The consensus among participants was that turmoil in global markets, resulting from the financial crisis in the U.S., has had limited impact on Argentina to date. Fitch's rep attributed this mainly to Argentina's relatively small financial sector and limited access to international capital markets (due to the threat of lawsuits from holdout bondholders). Nevertheless, Citi, supported by others, argued that the situation could change if the international crisis begins to impact global commodity prices.

Comment

¶13. (SBU) Financial sector participants were generally more downbeat than they have been in previous meetings with the Embassy. As Citi's rep highlighted, "we're all making money here, but you never know what will happen next." Clearly U.S. financial sector reps are discouraged by the lack of predictability in GoA economic decision-making. Instead of the "gradual fine-tuning" that many of these same institutions predicted in 2007 would occur under the Cristina Fernandez de Kirchner administration, there has been almost complete continuity on economic policies, with no significant reforms to date. As several lunch participants pointed out, most of the cabinet is unchanged and Nestor Kirchner still seems to be the top decision maker on economic issues. End Comment.

¶14. (U) CODEL Shelby cleared this message.

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